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2023 Investment Views:
EM Outlook

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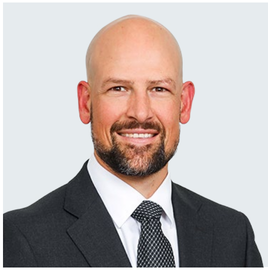

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The fast view

— While war in Ukraine and US inflation/rate hiking dominated market moves in 2022, prudent policymaking in many emerging market (EM) economies continued to bolster foundations.

— Inflation is receding and interest-rate hiking is drawing to a close in many EMs, giving policymakers greater scope to support a recovery.

— Key catalysts we expect in 2023 include a peak in the US dollar, with the Federal Reserve likely to be able to put the brakes on its rate-hiking cycle early in the year.

— War in Ukraine has seen many EMs ramp up efforts to shift to renewable energy, and compelling opportunities are arising for EM investors to profitably participate in the global energy transition.

— A managed exit from China's zero-COVID policy could unleash significant pent-up demand. Given how cheap Chinese assets have become, this is a key area for investors in EM equities and corporate bonds to watch.

— Fear was a key driving force of investor behaviour in 2022. This resulted in some major dislocations of asset prices relative to fundamentals. Active investors should look to harness these.

— Greater stability in the US Treasury market could spark a pronounced rebound in the EM corporate debt market, especially in segments like long-dated investment-grade debt.

— Orthodox monetary policy, peaking inflation and falling debt-GDP ratios present some compelling opportunities in local currency debt markets, especially in Latin America.

— In EM hard currency debt, valuations are particularly attractive in some frontier markets, where significant support is forthcoming from the IMF.

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The content of this communication is intended for readers with existing knowledge of financial markets.

Receding inflation as prudent policy pays off

We described last year how many emerging market (EM) central banks had acted quickly and prudently in hiking interest rates to prevent inflation spiralling out of control. While the impact of war in Ukraine and inflation/monetary policy dynamics in the US overshadowed this in 2022 and pressured financial markets across the world, the significance of proactive policymaking in EMs is undiminished. This, and generally good macro fundamentals such as current-account positions, should stand EM economies in good stead over the medium term.

While risks remain in Central and Eastern Europe – driven by labour shortages and energy market disruption – inflation is easing for much of the EM universe, with food prices and manufacturing input costs falling away abruptly and supply-chain disruption starting to improve. At the time of writing, four of the 18 largest EM local bond markets had paused hiking, having successfully reined in inflation. With many other EM economies now close to the end of their hiking cycle, we think investors have an attractive entry point. From the perspective of equity investors, countries where central banks have been ahead of the curve in raising rates – Brazil is a notable example – should benefit from policymakers having greater scope to support a recovery.

Commodity price strength a tailwind – in aggregate

While EMs have not been immune to global growth concerns, many have seen higher commodity prices boost their export revenues. The economic effect of this can be seen clearly in the IMF's latest growth forecasts, which point to a widening growth differential between emerging and developed markets (DMs) over the next few years, with a more pronounced slowdown predicted for DMs. That has positive implications for EM asset class relative performance. However, ongoing volatility and dispersion in commodity price moves will continue to impact countries' terms of trade to varying degrees, resulting in distinct winners and losers within the EM universe.

Ukraine conflict disruption amplifies both risks and opportunities

As touched on above, markets in Central and Eastern Europe have been impacted most severely by the war in Ukraine, with the spike in energy prices putting pressure on consumers. Elsewhere, higher food prices have weighed heavily on some African countries, while commodity exporters in Latin American countries and Gulf nations have benefitted significantly from higher commodity prices.

The picture is similarly diverse at the micro level: some companies have benefitted from war-related disruption to food and agriculture markets – e.g., those providing crop security. And many firms in the Middle East are benefitting hugely from higher oil and gas prices. In contrast, higher input costs have weighed on the profit margins of steel producers. This is a continuously evolving picture: as the financial impact of higher rates and slower global growth begins to test more vulnerable companies, investors will need to be selective.

Looking at the bigger picture, we are encouraged by the ramping up of efforts to shift to renewable energy. In India, for example, higher coal import costs have accelerated plans to transition the country's energy mix in favour of hydrogen. This is a phenomenon we are seeing across many EMs. The energy transition is being accelerated by the conflict in Ukraine, which has underlined the importance of energy security at the national level. Energy transition beneficiaries include many traditional industries, such as providers of resources and materials required in the build-out phase. We believe this presents some compelling opportunities for EM investors to profitably participate in the global transition.

Navigating China won't be easy but it's worth the effort

COVID-related restrictions in China were a strong headwind to growth in 2022. Those looking for a policy shift at China's 20th Party Congress in October were disappointed as the overarching theme was continuity. However, since then, there have been signs of easing this restrictive policy. A managed exit from zero-COVID has the potential to unleash significant pent-up demand. Given how cheap Chinese equities have become, this is a key area for EM equity investors to watch.

The reopening of China's economy would also be a precursor to a recovery in China's property market – where support provided until now has failed to dissipate the negative sentiment that has weighed on the EM corporate debt market. Ongoing efforts to stabilise the property sector and boost growth via higher spending on infrastructure should start a moderate recovery, which should be reinforced by an eventual easing of COVID restrictions. While China still faces significant medium- to longer-term structural growth challenges, the cyclical picture could brighten considerably.

Importantly for bond investors, it's not just on COVID policy that China has bucked the global trend. China tightened monetary (and fiscal) policy early to address overheating in 2021 and has been easing credit conditions just as the US and other countries have been doing the opposite. With domestic factors – muted growth and relatively benign inflation – driving China's onshore bond market, it has been insulated from major global headwinds and proven its worth as a diversifying allocation.

While investors are rightly concerned about geopolitical developments – including China's stance on Taiwan and trade tensions with the US – all things considered, we think the extreme negative sentiment among the global investment community is overdone in the short term. But there has been a policy shift over the past two or three years and investors need to navigate that prudently.

Potential turning points for markets

The key headwinds for EM bond markets in 2022 were interest-rate hikes to tackle persistent inflation (exacerbated by rising energy prices after Russia invaded Ukraine) and a lack of positive sentiment, both in terms of consumer confidence and investors' appetite for risk. Considering these in turn:

- Barring any major surprises, we believe the US Federal Reserve should be able to put the brakes on its rate-hiking cycle in the early part of 2023.
- Relatively high gas reserves should help Europe get through the winter months. Further ahead, the Ukraine crisis is likely to recede as a material influence on commodity prices, either through exhaustion and stalemate or a conclusive outcome on the battlefield. This should enable energy prices to subside further, although the geopolitical consequences of the crisis are likely to be felt for much longer.
- As for sentiment, we would need to see positive developments in the war in Ukraine and US/China trade tensions for a positive shift.

We also cannot ignore the challenging liquidity conditions that have driven some abrupt market moves. With the Fed's quantitative tightening programme still having some way to go, liquidity is likely to remain a headwind over the coming months and keep market volatility elevated.

For the EM equity market, short-term challenges remain as investors grapple with uncertainty around inflation, interest rates and growth. Over the longer term though, we have a positive outlook. Key catalysts we expect to see at some point in 2023 include a peak in the US dollar and interest rates. Coupled with historically low valuations for EM equities and light investor positioning, we think there is potential for strong performance on a 12 to 18-month view.

Investors should look through current volatility

Fear was a key driving force of investor behaviour in 2022. This resulted in some major dislocations of asset prices relative to fundamentals. Active investors should look to harness these.

In the EM hard currency debt market, the major sovereign borrowers are in reasonable shape, but this isn't necessarily reflected in current pricing. Valuations are particularly attractive in frontier markets such as Egypt, where investors have overlooked the significant financial support secured from the IMF and other institutions. Within local debt markets, we see some great opportunities in Latin America, where policy has been notably orthodox, inflation is peaking and debt-to-GDP ratios are falling, yet bond market valuations are not reflecting this.

In EM corporate bond markets, China stands out for its excessive risk premium. As things improve in terms of COVID policy, growth and US relations, we could see a powerful recovery in Chinese corporate bonds. Through a wider lens, EM corporate bond valuations are very attractive across the board and, once we see more stability in the US Treasury market, we could see a pronounced rebound, especially in market segments like long-dated investment-grade debt. Market dynamics in 2022 have driven many securities within the broad universe to valuation extremes, with particularly compelling value in BB/BBB rated bonds over the medium term. Another factor that is making us optimistic on the return outlook for the asset class is the very favourable supply/demand backdrop as net issuance has become negative.

Turning to EM equities, investors often overlook how wide the opportunity set has become and the significant improvement in the quality of companies and their corporate governance in various countries, with India a notable example. Areas where we see new opportunities include the Middle East, which is booming given elevated oil prices. Parts of Asia also offer interesting opportunities for growth, at very discounted valuations.

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